EFFECTS OF FOREIGN DIRECT INVESTMENT ON COMMERCIAL REAL ESTATE VALUES IN THE UNITED STATES

Alessandro Giovanni Bonis*

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* Alessandro Giovanni Bonis is an undergraduate student in the College of Business Administration Honors Program at California State University, Long Beach, CA 90840. This manuscript serves to fulfill his Honors Thesis requirement. Address correspondence to Alessandro Bonis: alessandro.bonis@hotmail.com

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ABSTRACT

The United States offers attractive investment opportunities to foreign individuals, firms, and governments. For decades foreigners have been gobbling up office buildings, hotels, industrial and residential properties, and retail complexes. The main driving forces of property values are interest rates, tax rates, and economic growth – variables that determine demand. Foreign demand might amplify downward or upward pressures on prices by a significant amount. As prices respond to changes in fiscal policies and economic growth, and foreign direct investment (FDI) constitutes a measurable portion of demand for real estate, these value fluctuations will be to some degree explained by inflows or outflows of foreign capital. The objective of this study is to determine if FDI has a significant effect on commercial real estate prices.

INTRODUCTION

The United States offers attractive investment opportunities to foreign individuals, firms, and governments. The United States continually invites foreign capital mostly because of its market and economy's relative stability, strength, and strict comprehensive laws governing disclosure and investor protection compared to foreign countries. Investment can be direct or indirect. Direct investment takes place when foreigners buy real property or open businesses on US soil. Indirect investment instead happens when foreigners invest in American companies through the purchase of stock and bonds, and through partnerships with American firms. While most foreign companies and governments invest primarily indirectly – China and Japan are the largest holders of US Treasuries with their combined assets totaling 50 percent of all foreign held US debt (USTreasury, 2006) – many also invest directly on US soil, especially in real estate.

American real estate is particularly attractive for the same reasons mentioned above: i.e., relative stability and tough disclosure laws provide a certain degree of security to offshore investors. For decades foreigners have been gobbling up office buildings, hotels, industrial and residential properties, and retail complexes. This influx of capital is pretty impressive. For example, in 2002 alone, foreigners invested $6.8 billion in office properties, $745.5 million in retail, $611 million in apartment buildings, and $262 million in industrial properties. These numbers are up 200% from 2001, but still lower than 2003 which saw a further increase of 184% of foreign capital influx into commercial properties (Luxenberg, 2004). In the 1980s and early 1990s, Japan was the single major holder of US commercial real estate; currently Germany, Canada, and Australia are the leaders in US real estate acquisitions. Japan, which retracted in the mid 1990s to cope with its financial crisis, is coming back stronger as its economy is recovering (Dorrel and Zerbst, 2000).

While there are certainly many benefits from a constant increasing inflow of capital, there are still potential concerns affecting local buyers. What happens when foreigners take control of large sections of the real estate in US cities and their most significant buildings and structures? Many Americans might not feel too comfortable knowing that foreign companies and governments own major urban landmarks as well as key business facilities and operations inside the US Aside from nationalistic feelings, protectionist attitudes, and security concerns, the issue at stake in this study is the effect of foreign acquisitions of American real estate on property values. Increasing interest in American properties and increasing spending from abroad could have the effect of disrupting the normal growth and stability of the US real estate market. Many international investors are willing to buy properties at a premium, easily outbidding American buyers. Although foreigners are paying more, these deals still constitute a bargain as similar properties in their home countries are selling at much higher prices; this is the case for Australians and Asians in particular (Dorrel and Zerbst, 2000). This trend has the potential of pushing up prices. Property values are derived by supply and demand, and if foreigners are fueling demand, logically prices should be adjusted upward. While this effect is delightful for property holders and sellers, it could put local buyers at a disadvantage. The purpose of this study is to determine if foreign demand for US commercial properties is penalizing American buyers by pushing real estate prices upward.

BACKGROUND, LITERATURE REVIEW, AND HYPOTHESIS

The Japanese were major investors in American real estate throughout the 1980 decade up until mid 1990 when they began disinvesting. An article from the *Los Angeles Business Journal* (Lino, 1993) claimed that “the Japanese own 30% of all high-rise ‘trophy’ office projects in downtown Los Angeles.” One of the peak periods for foreign investment in real estate was 1990, when more than $34 billion in property was purchased.

This wave of investment from the Far East was well appreciated as many American companies have made significant profits selling real estate assets to Japanese investors (Lino, 1993). In 1994 Japanese firms started selling their holdings in mass, as the US economy receded and the Japanese bubble busted. The Asian firms were hoping to recover 80 percent of the book value when instead they had to settle for less than 70 percent and in some cases just over 50 percent of the original value. This massive under-pricing further decreased price while increasing sales (Rodman, 1995).

As of 2004, foreign demand for real property is stronger than ever with Australians and Germans acquiring US shopping centers in many American cities. Traditionally, New York City, Los Angeles, and Chicago are major targets of foreign acquisitions; now however the attention is shifting to cities like Dallas, Atlanta, and San Diego, all of which feature hot lucrative markets (Luxenberg, 2004).

The Association of Foreign Investors in Real Estate (AFIRE) 2005 annual survey provides the following data:

- The top five US Cities for Real Estate Investment are Washington D.C., New York City, Los Angeles, San Francisco, San Diego.
- The countries supplying the most active investors are Germany (49.2%), Australia (40%), The Middle East (6.2%), and Ireland (4.6%).
- The most attractive property types in the US are ranked as (1) Office, (2) Hotel, (3) Retail, (4) Industrial, (5) Multifamily [1=most attractive; 5=least attractive].
- The USA ranked on top by far as the country providing the best opportunity for capital appreciation, and the country providing the most stable and secure real estate investments.

Interest rates, tax rates, and economic growth are regarded as the main driving forces of property values. Foreign demand might significantly amplify downward or upward pressures on prices. As prices respond to changes in fiscal policies and economic growth, and foreign direct investment

(FDI) constitutes a measurable portion of demand for real estate, these value fluctuations will be to some degree explained by inflows or outflows of foreign capital.

Supporting Literature and Empirical Studies

The direct relationship between foreign demand and real estate prices is already evident in some segments of the residential market. The *Wall Street Journal* article "Real Estate's Foreign Affair; Declining Dollar Enables Europeans to Buy US Homes, Pushing Up Prices for Locals" points out to the fact that because of a weaker US dollar and a strong Euro, many European are buying homes all along the East Coast at a fraction of the price they would have been charged at home (Simon, Hagerty, and Areddy, 2005). An important passage in the article states: "Foreign demand is helping to keep home prices lofty, exacerbating concerns about a housing bubble in the US while at the same time, pushing homes in some areas out of reach of local residents." (p. B1) On some occasions, foreign buyers outnumber locals on the sale of new developments. Increased demand from foreigners for residential real estate in Manhattan for example, has had the effect of increasing demand and pushing up prices (Chittum and Smith, 2005).

Foreign investment accounts for 24 percent of the institutional equity invested in all income-producing properties in the U.S (Leon, 2004). Because the demand is so high, bidding wars can become quite intense; foreigners and Germans in particular find themselves targeting Class-A assets which also attract many American institutional investors. Buyers are also willing to make non-refundable deposits to purchase an asset, or waive due diligence (Leon, 2004). Aggressive and sometimes risky investments usually result in inflated prices, leading to overpriced properties and overheated markets. "Strong demand for mortgage-backed securities from investors world-wide, for example, is allowing American lenders to make more loans-and riskier ones-in a way that is helping prolong the boom in US house prices". (Simon, James, and Areddy, 2005, p. A1). As of

August 2005, even though there's been a lot of talk about a pending housing bubble burst as the Federal Reserve Board continues to raise interest rates, prices continue to rise or remain at high levels as investors continue to dump capital into mortgage backed securities (Simon, Hagerty, and Areddy, 2005).

Other instances in which foreigners directly affect local prices can be found outside the United States. For example, in Baja California, Mexico, it is American buyers who turned small Mexican fishing villages into booming housing markets which now attract thousands of buyers and developers. This is the case of towns like Loreto, Los Cabos, and Rosarito. A few years ago it was possible to find beachfront residences for about $30,000; recently however prices have skyrocketed so much that locals are totally excluded from the market, and Americans too are beginning to find the prices prohibitive. Now prices range from $200,000 to $2 Million (Harman, 2005).

There aren't any substantive studies that investigate the foreign investment effect on valuation thoroughly; however, there are several that touch the subject indirectly. Ford, Fung, and Gerlowsky (1994) explored the factors affecting the choice of location for real estate investment in the US by foreigners. The main influence on location turns out to be the market potential for renters and other users of space. Higher prices diminish the attractiveness of real estate investment to foreigners; at the same time however it is foreigners' investment that contributes to the spike in real estate prices in some of the most desirable American locations. Urban areas in Florida, California, New York, and Texas attracted the most capital; indeed these are the locations presenting the highest prices, and the largest pool of renters and users.

Webb, He, and Myer (1992) studied the wealth effects of US real estate being acquired by non-US firms. Their study supports that sell-offs result in significant gains in wealth for the selling firm's shareholders; however no significant difference was found between returns from sell-off to American buyers and sell-offs to non-American buyers. Finally Webb, He, and Myer (1992) determined that non-US buyers do not have an advantage in bidding on US real estate.

On the other hand, Nelson and Ogawa (1991) wrote a paper studying in depth the flood of Japanese capital into American real estate. This study is very interesting as it clearly defines the amount of capital invested in each category of commercial real estate, and the type of firms involved. Not only did properties experience further appreciation following these deals, but the Japanese were willing to buy them at a premium following a very aggressive investment strategy. Although the newly acquired 'trophy' buildings in American downtowns were quite expensive, these properties were still a bargain in relation to comparable properties in Japan. This conclusion stands in contrast of the study by Webb, He, and Myer (1992) which concluded that non-American buyers don't have a bidding advantage. Technically the playing field is leveled; however the advantages to foreign investors lie in the fact that the value of properties in their respective home countries is already inflated, and America constitutes an economic opportunity. In summary, the previous studies do support a relationship between FDI and property values, but say nothing about the extent and weight of this influence.

Hypothesis:

H1: Foreign investment in American commercial real estate increases property values, thus putting local buyers at a disadvantage.

METHODOLOGY

Collection of Foreign Direct Investment (FDI) Data

Foreign Direct Investment data was retrieved from the Bureau of Economic Analysis (B.E.A.) website. The numbers representing the amount of direct capital flowing to the US needed to be collected over a constant and long enough time period, categorized by industry sector, and most importantly by state or region of destination. Currently, the only free government sources of such data are the yearly tables compiled by the B.E.A. displayed in the International Economic Accounts section.[1] These tables are part of an annual report on comprehensive financial and operating data concerning foreign enterprises conducting business in America. The years covered range from 1977 to 2003. Each report consists of about 90 excel spreadsheets featuring balance sheets, income statements, as well as employment, taxation, industries, property, plant, and equipment data of US affiliates of foreign companies. Tables D.12, D.14, G.7, and G.14 show numbers (in millions $) organized by state and industry. Ultimately, the data in Table D.12, featuring real estate, rental, and leasing investment totals by foreign affiliates for each US state, was used to test H1. As previous research showed that Washington D.C., San Francisco, San Diego, Los Angeles, New York, and recently Houston, and Dallas are the most attractive urban centers for commercial investments, only the numbers for California, Texas, and District of Columbia were used. New York was excluded as not enough properties' prices data was found for this state.

Collection of Commercial Real Estate Prices

Historical prices were obtained from the National Real Estate Index Market History reports, currently available at the Los Angeles Central Library. The tables are comprised of quarterly

[1] www.bea.gov> International > "Financial and operating data – selected tables" under Foreign Direct Investment in the U.S. > Additional Data for U.S. Affiliates > find Exe and Zip files from 1977 to 2003.

figures for each year from 1985 to 2006, representing average price changes for several property categories including central business district (CBD) office, suburban office, retail, residential, and industrial. Values for CBD offices, retail buildings, and industrial properties were used for the current study. Previous research and surveys from the Association of Foreign Investors in Real Estate (AFIRE) suggest that these are the property categories that most likely attract foreign investment. The quarterly numbers were averaged out into one yearly figure to keep the data consistent with the figures available from the B.E.A. reports which offer only yearly figures. Analyses are based on the estimates for the 19 year-period 1985-2003, mainly because this is the time span for which there is complete data available for FDI and commercial property prices.

RESULTS

Regression Analysis – Overall Model

After gathering all 19 years of data, including CBD office, industrial building and retail-use building prices, and foreign direct investment amounts of the six major cities sampled, an aggregated regression analysis was performed. This analysis was performed to determine if the shifts in Foreign Direct Investment amounts had significant effects on commercial real estate prices. A regression model specified average Foreign Direct Investment amounts as an independent predictor of commercial real estate prices. In addition, five city dummy variables and the associated five city x FDI interaction terms were also included as predictors. The overall model was significant ($F(11,330)=6.451$, $p=0.000$) with an R^2 of 0.177, indicating that only 17.7% of the variance in the dependent variable (average commercial real estate prices of CBD buildings, industrial buildings, and retail-use buildings) was explained by this set of independent variables (average Foreign Direct Investment in the six cities). However, none of the individual predictors attained statistical significance, likely due to the “pooling” across sectors (i.e., CBD office, industrial, and retail). For example, while larger FDI is associated with lower commercial real estate prices (*b*=-.26; *t*=-1.262), this relationship is not statistically significant (*p*=.20).

Thus, two dummy variables were created to distinguish the three real estate sectors. When these two dummy terms and their interactions with FDI were added to the model specified above, the R^2 increased to an impressive .784 (*F*(15,326)=78.69, *p*<.001) with the two sector dummy variables and the Office x FDI interaction term (*b*=-.21, *t*=-3.46, *p*=.001) significant predictors: the data indicate that overall, average real estate prices are higher in the office sector (*b*=.39, *t*=12.86, *p*<.001) and lower in the industrial sector (*b*=-.50, *t*=-16.60, *p*<.001). Based on the incremental contribution of the sector terms (incremental *F*(4,326)=229.03, *p*<.001), models were estimated for each of the real estate sectors. (See Tables 1 and 2.)

[Insert Tables 1 and 2 about here.]

Regression Analysis – CBD Office Prices

An individual regression analysis was performed to determine if the shifts in Foreign Direct Investment amounts had significant effects on CBD office prices. The same set of independent predictors used above in the aggregate model was used here. The overall model was significant (*F*(11,102)=22.55, *p*=0.000) with an R^2 of 0.709, indicating that 70.9% of the variance in the dependent variable (average commercial real estate prices of CBD offices) was explained by this set of independent variables (average Foreign Direct Investment and city-related dummy and interaction terms). Examination of the individual beta coefficients for this regression model suggest that on average, larger FDI is associated with lower commercial real estate prices (*b*=-.52; *t*=-2.38, *p*=.019). In addition, CBD office real estate prices were lower in Houston (*b*=-.88, *t*=-2.45, *p*=0.016) and Dallas (*b*=-.94, *t*=-2.62, *p*=0.01). None of the city dummy x FDI terms were significant, indicating that the relationship between FDI and real estate prices does not vary across the six cities examined here.

Regression Analysis – Industrial Building Prices

An individual regression analysis was performed to determine if the shifts in Foreign Direct Investment amounts had significant effects on industrial building prices. A regression model specified average Foreign Direct Investment amounts as independent predictor of industrial building prices. The overall model was significant ($F(11,102)=11.14$, $p=0.000$) with an R^2 of 0.546, indicating that 54.6% of the variance in the dependent variable (average commercial real estate prices of industrial buildings) was explained by this set of independent variables (average Foreign Direct Investment in the six cities). Examination of the individual beta coefficients for this regression model suggest that on average, larger FDI is associated with lower commercial real estate prices ($b=-.48$; $t=-1.78$, $p<.10$). For the industrial real estate sector, real estate prices are marginally lower in Washington D.C. ($b=-.65$, $t=-1.88$, $p=0.063$), Houston ($b=-.76$, $t=-1.70$, $p=0.092$), and Dallas ($b=-.76$, $t=-1.69$, $p=0.094$). No other terms were significant in this model.

Regression Analysis – Retail Building Prices

A final regression analysis was performed to determine if the shifts in Foreign Direct Investment amounts had significant effects on retail building prices. The overall model was significant ($F(11,102)=25.72$, $p=0.000$) with an R^2 of 0.735, indicating that 73.5% of the variance in the dependent variable (average commercial real estate prices of retail buildings) was explained by this set of independent variables (same as those used above). As above, for the retail sector, larger FDI is associated with lower commercial real estate prices ($b=-.38$; $t=-1.82$, $p<.10$). In addition, prices are lower in Houston ($b=-.57$, $t=-1.66$, $p<.10$). The data found no evidence that the relationship between FDI and prices varied across these six sampled cities.

DISCUSSION

The overall regression analysis determines that FDI is indeed a predictor of real estate prices. The individual (sector) regressions suggest that 50 to 70 percent of the change in prices is explained by FDI amounts. Nevertheless, such relationship does not appear to vary much across the six sampled cities; Houston, Washington, and Dallas reported slightly lower prices.

In general, larger amounts of FDI are associated with decreasing property prices. This negative association is more evident in the individual models, while less significant in the overall model, and conflicts with H1 that FDI increases prices. While H1 implies that there is a positive, linear relationship between the two variables; the data are unable to establish that commercial real estate prices are being inflated by inflows of foreign capital and that local buyers are being penalized. Foreign direct investment can predict prices to a degree, but larger amounts are not associated with higher prices.

The negative association could perhaps be explained if a reversed relationship is in effect: i.e., in which prices determine the amount of foreign capital. This is consistent with the study by Ford, Fung, and Gerlowsky (1994) which explains how higher prices diminish the attractiveness of such investments. Therefore, any surge in prices would deter further investment. Foreign firms, logically, would look for the best investments in good locations were prices are dropping. With such a scenario it would be interesting to determine if FDI is actually preventing prices from dropping further. Such a conclusion would imply that FDI is indeed serving to raise prices.

The current results indeed show that foreign investors are much more eager to save capital and look for bargain deals than what previous literature demonstrated. Some of the articles touching on this issue give the impression that foreign investors would buy any property at any price in the US, simply because prices are still cheaper than in other cities worldwide. Even so, foreigners invest less when prices are increasing.

The current study shows surprising results that stand in contrast to previous findings. Different effect patterns were expected in different cities with different property categories. Research would suggest that California should show a greater relationship between office prices and FDI, while Texas should show a stronger relationship with retail properties. Within California, Los Angeles should be expected to show a greater correlation throughout all three property types, as the city's economy is much diversified. Downtown office buildings, retail centers, and industrial facilities are all largely present across downtown Los Angeles, its suburbs, and the county. On the other hand, San Francisco should attract FDI mainly toward its high-rise office buildings that typically attract investments from Europe and Asia. The results did not support any of these predictions, and the FDI-price relationship remained constant across cities. The economic base of each city was not investigated in depth, so not enough information is available to examine why different FDI-price patterns were not present across cities.

The individual models did show greater significance for the office and retail sectors, and this was expected. Generally, office and retail are primary targets of foreign acquisition, while industrial-use buildings are usually less attractive; therefore less foreign capital goes toward this category – at least in the US. Developing countries like China, India, and Latin America attract much larger investment toward industrial facilities due to their low labor costs. Foreign direct investment in American commercial real estate amounts to $billions every year, and the presence of this large amount of capital has an impact on valuation. Nevertheless, such impact will not always be evident as prices are still driven by stronger economic forces.

CONCLUSION AND FUTURE RESEARCH

Considering the type of data and resources currently available, pursuing this kind of research can be difficult. This study was conducted using FDI measured by states. Unfortunately, more accurate figures were not available; however, a more reliable association with property prices could be tested using the specific amount of FDI going to each business district and urban location. Such data is probably available only through the financial institutions that sponsor these sales and acquisitions. Currently, organizations and firms like Real Capital Analytics, CB Richard Ellis, Grubb and Ellis, and Colliers International collect detailed commercial real estate investment data. However, this information is not accessible to the public, at least not for free.

Another limitation to the accuracy of the results reported above is the effect of other external variables. A clear understanding of the relationship between FDI and real estate values might be uncovered after isolating the effect of other factors such as interest rates, taxes, and economic conditions. Such study would require the effort of collecting tax rates, interest rates, and economic outlook data specific to the location being studied which is not always available. Nevertheless, such an analysis would yield more insightful and conclusive findings.

Furthermore, a different type of study would perhaps demonstrate greater variance across cities by sampling cities with very different economies. Manhattan, for example, would probably show a greater FDI-price relationship with CBD office buildings, while Detroit might show a greater relationship with industrial buildings. These, of course, are only assumptions; however for a future study, cities should be chosen with different economic bases that attract large international interest. Future research could perhaps concentrate on overcoming these obstacles, thus providing more understanding.

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TABLE 1 **AVERAGE REAL ESTATE PRICES**				
	CBD Office	**Industrial**	**Retail**	**FDI**
Houston	$106.07	$29.21	$80.10	$7,208.21
Dallas	$129.09	$32.69	$101.57	$7,208.21
Washington D.C.	$269.72	$43.37	$132.40	$2,161.68
San Francisco	$237.91	$57.21	$153.71	$19,136.26
San Diego	$148.76	$49.13	$125.58	$19,136.26
Los Angeles	$208.81	$56.61	$143.71	$19,136.26
Overall	$183.39	$44.70	$122.84	$12,331.15
Total of all property types combined			$116.98	

TABLE 2
REGRESSION ANALYSIS SUMMARY STATISTICS

Sector Type	**R Square**	**ANOVA**		
		df	*F*	*p*
Aggregate	0.177	11, 330	6.451	0.000
CBD Office	0.709	11,102	22.551	0.000
Industrial	0.546	11,102	11.139	0.000
Retail	0.735	11,102	25.716	0.000